



**THE HARMON FIRM LLC**

November 13, 2002

FinCEN  
P.O. Box 39  
Vienna, VA 22183

Re: Section 352 Anti-Money Laundering Program Regulations;  
Unregistered Investment Companies - Hedge Funds

To Whom It May Concern:

I am concluding the year-long writing of an article dealing with counter-terrorism and money laundering. The article suggests national strategy, policy and tactics to be employed in destroying the financial base of Al Qaeda, with a particular emphasis on the central role of financial institutions. I applaud Treasury for what must be an around-the-clock drive to implement the USA Patriot Act.

Please accept this as a comment from this firm on Treasury's proposed USA Patriot Act regulations, 67 FR 60617 (September 26, 2002), regarding anti-money laundering programs in so far as they would apply to hedge funds.

I have some familiarity with the subject of money laundering through experience and theory, in part, as executive director and chief counsel of the President's Commission on Organized Crime during the Reagan administration. In 1984, the Commission proposed and advocated the first anti-money laundering law and strategy, including "Know Your Customer" measures. This led to the enactment of the first criminal anti-money laundering statute.

**The Threat of Terrorist Financing**

It is true (as Treasury notes with examples) that hedge funds are subject to the risk of money laundering. In the context of terrorism, the most significant risk is that the hedge fund itself was designed and intended to finance terrorism covertly. This means that a foreign terrorist financier could establish or "invest" in a hedge fund with no interest in any return on investment. Laundering, not profit, would be the purpose of the foreign terrorist financier who is a hedge fund "investor."

The scenario would be as follows: The terrorist supporter invests millions in a hedge fund, as do unsuspecting legitimate investors. Complicit hedge fund management either does or does not further invest all or part of the pooled investor capital. The terrorist financial supporter is prepared to sustain a 10-15% loss or more, but considers it a fee for laundering services - the cost of doing terrorist business. The "laundering fee" is paid to unsuspecting legitimate investors as a return on their investment. The net balance of the investment in terrorism is transmitted from the hedge fund to an account where it can be used to support operations. Bogus business records support the entire

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scheme, which may be thought of as the "shell" hedge fund scheme.

This troubling scenario explains why the interests of a legitimate hedge fund investor are aligned with Treasury's counter-terrorism measures. A legitimate hedge fund investor wants no part of money laundering. By investing elsewhere, such a legitimate investor can effectively isolate those few bad actors who would compromise a hedge fund through money laundering.

The possibility of a "shell" hedge fund may seem remote. It is not. For example, the CFTC recently brought suit against an individual, and a variety of entities which he owned, managed or controlled, for fraudulently misappropriating \$10.6 million from 29 investors who believed that they were investing in hedge funds when, in fact, the defendant organizer/owner/manager allegedly used their money for business, personal and luxury expenses. Among other things, the organizer allegedly fabricated an account statement which reflected the "trading" output of a dummy account through non-existent brokerage firms. Complaint, CFTC v. O'Neill et al., docket no. 02-61307-civ-gold (S.D. Fla. September 17, 2002). In another case, the defendants, including a hedge fund manager, were convicted of conspiracy to commit racketeering in an organized crime and labor union pension fund fraud and kickback scheme which would have generated \$150,000 - \$200,000 in kickbacks for each \$1 million dollars of pension fund assets invested by three union pension funds. U.S. v. Black et al., 2002 U.S. Dist. LEXIS 4948 (S.D.N.Y. March 25, 2002).

### **The Need for Information**

As a licensed investigations company, this firm conducts due diligence in variety of contexts including hedge funds. Many hedge funds are organized offshore, mainly in Bermuda, the Cayman Islands and the British Virgin Islands. Their offshore character, and their reliance on associated entities, e.g., asset acquirers and marketers, make due diligence especially difficult. Little information of significance normally can be found in the jurisdiction of organization. Any problems will arise from persons behind the corporate or other veil. As a result, reported information is essential to enable Treasury to know who is really behind a hedge fund and to enable legitimate investors to know where not to invest.

### **Recommendations**

Treasury is in a unique and important position to empower the legitimate hedge fund investor by enabling the investor to conduct pre-investment due diligence. In order to mobilize the legitimate hedge fund investor base in Treasury's effort to stem terrorist financing, the following actions are recommended:

- 1) Hedge funds take different legal forms. They may be corporations, partnerships, limited liability companies or other some other legal entity. In the proposed Notice to FinCEN, Treasury should require the identification of a hedge fund's asset manager, financial advisor, ownership (including beneficial ownership), general partner, marketers, asset acquirers, accountants and functionally equivalent control

persons, as well as the hedge fund's fiscal year. In order to insure transparency, the obligation to disclose should extend through all layers of ownership, until individual, personal owners are identified. At each layer of ownership, disclosure should include dates of birth and the jurisdiction in which a hedge fund entity was organized and when; and

2) Material changes in assets under management or the number of investors or dissolution of a hedge fund could be indicia of money laundering. Consideration should be given to requiring disclosure of material asset and investor changes and dissolution or similar events; and

3) FinCEN Notices from unregistered investment companies should be available to the public online through a database searchable by each item and fact reported.

### **Relationship to Customer Identification and Private Bank Account Regulations**

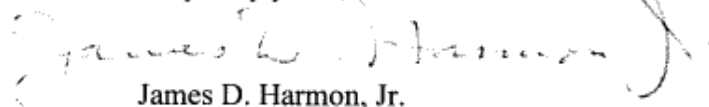
Until adoption of the proposed regulations, Treasury has temporarily exempted unregistered investment companies from the obligation of establishing and maintaining anti-money laundering programs. At the same time, the USA Patriot Act requires all financial institutions to establish customer identification and verification procedures, and to conduct due diligence with respect to private banking accounts of non-US persons.

Almost by definition, many hedge fund interests are private banking accounts. A private banking account is an account (or any combination of accounts): 1) which requires a minimum aggregate deposits of funds or other assets of not less than \$1,000,000; 2) is established on behalf of one or more individuals who have direct or beneficial ownership interest in the account, and 3) is administered by a specific employee acting as liaison between the financial institution and the direct or beneficial owner of the account. 31 U.S.C. § 5318 (i) (2) (B).

As we understand it, by interim final rule, Treasury has deferred the application of the due diligence for foreign private bank account regulations for all financial institutions except banks, securities broker/dealers, futures commission merchants and introducing brokers. 67 FR 48348 (July 23, 2002). In the interest of clarity, Treasury should make clear that the temporary exemption from the anti-money laundering program requirement did not limit in any way the duty of hedge funds to establish and maintain customer identification/verification and private banking due diligence practices.

Keep up the good work.

Very truly yours,

  
James D. Harmon, Jr.